



## Letter n°75

### **Two consequences of the war in Ukraine for the global economy and markets : (1) The acceleration of the energy transition.**

*"Russia does not know where it begins and ends. Despite being the largest country in the world, it still feels cramped and threatens the small neighboring countries that surround it." Vaclav Havel in 2008.*

Let's set aside this insightful political remark by Vaclav Havel in 2008 and focus on two economic and market questions. The energy transition and a price-wage inflationary spiral are two of the impacts of this war in Ukraine.

In other words, there is satisfaction arising from the acceleration of the energy transition, which is examined in this Letter 75, and frustration caused by longer-lasting inflation, which will be analyzed in Letter 76.

To be fair, the war in Ukraine is not the sole cause of the acceleration of the energy transition: the replacement of Trump, the "climate skeptic", by Biden and the IRA vote or the various climate summits all contribute to the momentum for the energy transition.

Although it is not the root cause of the issue being analyzed here, the war in Ukraine acts as an amplifier, but to tell the truth, the title of this Letter 75 needs to be nuanced.

While there is indeed an acceleration of the energy transition, there is also, unfortunately, an increased reliance on coal. And, with these two aspects, the sunny and the dark, we must discuss recent developments because these investments, beyond the energy transition, are driven by a concern for energy independence.

Let's examine these two trends in turn.

#### **The acceleration of energy efficiency and increase in investments in renewable energy:**

The price of gas is regional and, compared to the average price in 2019, it has increased by a factor of 14 in Europe, 8 in Asia, and 3 in the United States at its worst in 2022, creating competition distortions in the industry and forcing actors to reduce their consumption.

In Europe, between August and November, despite subsidies provided by states to cushion price increases, gas consumption decreased by 20% compared to its average from 2017 to 2021. This is a combination of two phenomena: mild winter temperatures and less wastage. In other words, economic growth has required less energy.

In 2022, according to the IEA, \$1.4 trillion would have been invested in renewable energy, representing nearly three-quarters of energy investments. However, this is still insufficient as the IEA estimates that \$4 trillion per year in clean energy investments are required to limit global warming to 1.5 degrees.

For the first time in 2022, wind (15.3%) and solar (7%) energy combined produced more electricity in Europe than coal (18%) or gas (18%) while nuclear electricity accounted for 23.6%.

Europe's dependence on Russian oil imports fell from 26% in 2021 to 20%, and for gas from 38% to 15%. Europe was able to compensate for the loss of 75 billion cubic feet previously coming from Russia and the closure of Nord Stream I.

## - **Europe:**

While the development of renewable energies is undeniable and benefits from the rapid fall in production costs, selectivity is necessary on the stock market. Vestas and Gamesa (€940 million net loss in 2022), the European leaders, have reported a difficult environment in Europe with rising equipment costs, strong Chinese competition, and government pressure on prices. The three Chinese competitors, Mingyang, Windey, and Goldwind, are more profitable because they benefit from a large domestic market.

In total energy production, England with 50% of its electricity generated from renewable energies, and France with the combined weight of nuclear (36%) and renewable energies (8%) are ahead of Spain (cumulative at 27%), Germany (23%), and Italy (12%). Italy, however, is attempting to redirect its European recovery plan package towards renewable energies with developments in solar in Sicily and decarbonization.

## - **The United States:**

Let's not overestimate the American competition represented by the IRA and rejoice in the American shift towards energy transition. \$370 billion over 10 years is \$37 billion per year, which is 0.2% of GDP, equivalent to what France is doing, less than Germany in terms of GDP percentage, and less than the 0.5% of GDP allocated to green sectors by the EU.

## - **China:**

China is undoubtedly the world's largest investor in renewables, especially solar, with nearly 140GW of new capacity installed in 2021, far ahead of the EU and the US, both at 40 GW.

In China, nuclear power currently represents only 3% of electricity production and coal accounts for 60%, but 17 nuclear power plants are under construction to have the world's largest capacity by 2030. Finally, China has one-third of the world's capacity in solar and wind power.

In China, one-third of cars sold are electric, but after the reduction of subsidies, electric vehicle purchases in January 2023 were 6% lower than in January 2021, and as a result, the price of lithium, an important component of batteries, has dropped 30% in three months since its peak of \$62,000/ton in November.

## - **Saudi Arabia:**

Saudi Arabia continues to diversify its revenues (equivalent to 30% of GDP for non-oil revenues) to try to develop the solar industry, a sector in hydrogen, and decarbonization projects.

## - **Japan:**

Japan, once at the forefront of nuclear power with 50% of its electricity produced this way, is striving to revive it as nuclear power's share of electricity production fell to 7% after Fukushima.

On a global scale, according to BP, due to a faster-than-expected development of renewable energy, global crude oil demand in 2035 could be only 93Mb/d, a level 5% lower than previous estimates, and so would be the demand for gas. In the meantime, the demand for oil would remain around 100Mb/d.

On the markets, investors can buy companies in these different segments of solar, wind, hydrogen, but also position themselves on metals such as lithium, whose demand, according to the IEA, should be multiplied by 6 in the world by 2030. But caution is advised, as despite the recent drop, prices, recently at \$75,000/t in Europe, remain 8 times higher than at the beginning of 2021, even more so compared to the \$5,600/t in August 2020, and are much higher than production costs.

According to the IEA, over the next 5 years, capacity additions in renewables will be equivalent to all investments made in the past 20 years.

## **Continued dependence on coal and hydrocarbons:**

At the end of 2022, global demand for crude oil exceeded pre-Covid levels, reaching 101.1 million barrels per day.

After an increase in demand of 2.5Mb/d in 2022, OPEC revised its forecast upward to +2.3Mb/d this year, i.e. +2.3% over 1 year, with an expected increase of 590,000b/d in China. The IEA anticipates a demand of 101.7Mb/d. Oil company investments remain 45% below the peak of 2014 but increased by nearly 15% in 2022. Persian Gulf countries are investing heavily.

In the longer term, the increase in the middle class worldwide and the growth of the global population from 8 billion to 10 billion by 2050 will sustain the dependence on fossil fuels.

#### - **Investments in the Middle East:**

In this perspective, Saudi Arabia plans to increase its production capacity from 12Mb/d to 13Mb/d by 2027 and Aramco will invest \$40 to \$50 billion. At the same time, the UAE will increase its capacity from 4 to 5mb/d with projected investments of \$150 billion, and Qatar will spend \$80 billion to develop its gas capacities.

Similarly, the demand for coal has increased and it is the only commodity whose price at the end of 2022 was significantly higher than at the end of 2021.

#### - **Investments in China:**

China remains the world's largest polluter with one third of greenhouse gas emissions, far ahead of the United States at 12.5% and the EU at 7.5%. It represents 15% of global crude oil demand, 10% of gas demand, but 55% of metals demand.

The country benefits from its relationships with Russia (increased purchases by 16% in 2022 to 1.9Mb/d), Iran, and Venezuela to buy oil at reduced prices, often paid in Yuan, thus improving the competitiveness of its industry and attracting companies like BASF.

China is planning to build over a hundred new thermal power plants, and in 2022, six times more construction started than in the rest of the world, contradicting its commitment to carbon neutrality by 2060.

#### - **Developments in Russia:**

In Russia, the economy remains dominated by hydrocarbons, accounting for 20% of GDP and 50% of exports. In 2022, while gas exports, according to the Russian Ministry, declined by 25%, crude oil exports increased by 7.5%. The only positive point, for the medium term, according to Rystad, is that exploration investments, due to sanctions on deliveries of equipment, fell from \$45 billion in 2021 to \$35 billion in 2022.

Russia will be the loser in the redirection of gas flows from Europe. In 2021, 40% of European gas came from Russia. This share is gradually disappearing and it will take time for Russia to develop gas pipelines to Asia. Work on the second pipeline to China through Mongolia, Power of Siberia II, 2600 km long, will not begin until 2024 and is expected to be completed in 2030.

**To conclude, "All the darkness in the world cannot extinguish the light of a single candle" Reza.**

Let us rejoice because despite increased use of coal, greenhouse gas emissions in Europe decreased by 2.2% in 2022.

Let us rejoice in Vladimir Putin's failure to provoke a surge in energy prices, supply disruptions, social unrest, divisions in the Western camp, and a recession.

From a high of \$140/barrel in 2022, the price of Brent has fallen to \$84/barrel today, a level lower than at the start of the war. The same goes for the price of gas, which fell from a high of €340/MWh to €47/MWh today, and electricity prices, which fell from €929 at the highest to €147 today.

All these declines, sometimes more than 80%, will eventually lead to a decrease in inflation rates, the subject of Letter 76.

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